

paragraphs (b)(5) and (f)(2)(ii) of this section. See section 933(2) and § 1.933-1(b) for rules on attribution of income.

(h) *Information reporting requirement.* The following individuals are required to file notice of their new tax status in such time and manner as the Commissioner may prescribe by notice, form, instructions, or other publication (see § 601.601(d)(2) of this chapter):

(1) Individuals who take the position for U.S. tax reporting purposes that they qualify as bona fide residents of a possession for a tax year subsequent to a tax year for which they were required to file Federal income tax returns as citizens or residents of the United States who did not so qualify.

(2) Citizens and residents of the United States who take the position for U.S. tax reporting purposes that they do not qualify as bona fide residents of a possession for a tax year subsequent to a tax year for which they were required to file income tax returns (with the Internal Revenue Service, the tax authorities of a possession, or both) as individuals who did so qualify.

(3) Bona fide residents of Puerto Rico or a section 931 possession (as defined in § 1.931-1T(c)(1)) who take a position for U.S. tax reporting purposes that they qualify as bona fide residents of that possession for a tax year subsequent to a tax year for which they were required to file income tax returns as bona fide residents of the United States Virgin Islands or a section 935 possession (as defined in § 1.935-1T(a)(3)(i)).

(i) *Effective date.* Except as provided in this paragraph (i), this section applies to taxable years ending after January 31, 2006. Paragraph (h) of this section also applies to a taxpayer's 3 taxable years immediately preceding the taxpayer's first taxable year ending after October 22, 2004. Taxpayers also may choose to apply this section in its entirety to all taxable years ending after October 22, 2004 for which the statute of limitations under section 6511 is open.

[T.D. 9248, 71 FR 5001, Jan. 31, 2006, as amended by T.D. 9297, 71 FR 66234, Nov. 14, 2006]

§ 1.937-2T Income from sources within a possession (temporary).

(a) *Scope.* Section 937(b) and this section set forth the rules for determining whether income is considered to be from sources within a particular possession (the relevant possession) for purposes of the Internal Revenue Code, including section 957(c) and Subpart D, Part III, Subchapter N, Chapter 1 of the Internal Revenue Code, as well as section 7654(a) of the 1954 Internal Revenue Code (until the effective date of its repeal). Paragraphs (c)(1)(ii) and (c)(2) of this section do not apply, however, for purposes of sections 932(a) and (b) and 935(a)(3) (as in effect before the effective date of its repeal). In the case of a possession or territory that administers income tax laws that are identical (except for the substitution of the name of the possession or territory for the term *United States* where appropriate) to those in force in the United States, these rules do not apply for purposes of the application of such laws. These rules also do not affect the determination of whether income is considered to be from sources without the United States for purposes of the Internal Revenue Code.

(b) *In general.* Except as provided in paragraphs (c) through (i) of this section, the principles of sections 861 through 865 and the regulations thereunder (relating to the determination of the gross and the taxable income from sources within and without the United States) generally shall be applied in determining the gross and the taxable income from sources within and without the relevant possession. In the application of such principles, the name of the relevant possession shall be used instead of the term *United States*, the term *bona fide resident* of followed by the name of the relevant possession shall be used instead of the term *United States resident*, and the term *domestic* shall be construed to mean created or organized in such possession.

(c) *U.S. income—(1) In general.* Except as provided in paragraph (d) of this section, income from sources within the relevant possession shall not include any item of income determined under the rules of sections 861 through 865 and the regulations thereunder to be—

(i) From sources within the United States; or

(ii) Effectively connected with the conduct of a trade or business within the United States.

(2) *Conduit arrangements.* Income shall be considered to be from sources within the United States for purposes of paragraph (c)(1) of this section if, pursuant to a plan or arrangement—

(i) The income is received in exchange for consideration provided to another person; and

(ii) Such person (or another person) provides the same consideration (or consideration of a like kind) to a third person in exchange for one or more payments constituting income from sources within the United States.

(d) *Income from certain sales of inventory property.* For special rules that apply to determine the source of income from certain sales of inventory property, see § 1.863-3(f).

(e) *Income from services—(1) No de minimis rule.* In applying the principles of section 861 and the regulations thereunder pursuant to paragraph (b) of this section, the exception in section 861(a)(3) shall not apply.

(2) *Service in the Armed Forces.* In the case of a member of the Armed Forces of the United States, the following rules shall apply for determining the source of compensation for services performed in compliance with military orders:

(i) If the individual is a bona fide resident of a possession and such services are performed in the United States or in another possession, the compensation constitutes income from sources within the possession of which the individual is a bona fide resident (and not from sources within the United States or such other possession).

(ii) If the individual is not a bona fide resident of a possession and such services are performed in a possession, the compensation constitutes income from sources within the United States (and not from sources within such possession).

(f) *Gains from certain dispositions of property—(1) Property of former U.S. residents.* (i) Income from sources within the relevant possession shall not include gains from the disposition of

property described in paragraph (f)(1)(ii) of this section by an individual described in paragraph (f)(1)(iii) of this section. See also section 1277(e) of Public Law 99-514 (100 Stat. 2985) (providing that gains from the disposition of certain property by individuals who acquired residency in certain possessions shall be considered to be from sources within the United States).

(ii) Property is described in this paragraph (f)(1)(ii) when the following conditions are satisfied—

(A) The property is of a kind described in section 731(c)(3)(C)(i) or 954(c)(1)(B); and

(B) The property was owned by the individual before such individual became a bona fide resident of the relevant possession.

(iii) An individual is described in this paragraph (f)(1)(iii) when the following conditions are satisfied—

(A) For the taxable year for which the source of the gain must be determined, the individual is a bona fide resident of the relevant possession; and

(B) For any of the 10 years preceding such year, the individual was a citizen or resident of the United States (other than a bona fide resident of the relevant possession).

(iv) If an individual described in paragraph (f)(1)(iii) of this section exchanges property described in paragraph (f)(1)(ii) of this section for other property in a transaction in which gain or loss is not required to be recognized (in whole or in part) under U.S. income tax principles, such other property shall also be considered property described in paragraph (f)(1)(ii) of this section.

(v) If an individual described in paragraph (f)(1)(iii) of this section owns, directly or indirectly, at least 10 percent (by value) of any entity to which property described in paragraph (f)(1)(ii) of this section is transferred in a transaction in which gain or loss is not required to be recognized (in whole or in part) under U.S. income tax principles, any gain recognized upon a disposition of the property by such entity shall be treated as income from sources outside the relevant possession if any gain recognized upon a direct or indirect disposition of the individual's interest in such entity would have been so treated

under paragraph (f)(1)(iv) of this section.

(2) *Special rules under section 865 for possessions*—(i) Except as provided in paragraph (f)(1) of this section—

(A) Gain that is considered to be derived from sources outside of the United States under section 865(g)(3) shall be considered income from sources within Puerto Rico; and

(B) Gain that is considered to be derived from sources outside of the United States under section 865(h)(2)(B) shall be considered income from sources within the possession in which the liquidating corporation is created or organized.

(ii) In applying the principles of section 865 and the regulations thereunder pursuant to paragraph (b) of this section, the rules of section 865(g) shall not apply, but the special rule of section 865(h)(2)(B) shall apply with respect to gain recognized upon the liquidation of corporations created or organized in the United States.

(g) *Dividends*—(1) *Dividends from certain possessions corporations*—(i) *In general*. Except as provided in paragraph (g)(1)(ii) of this section, with respect to any possessions shareholder, only the possessions source ratio of any dividend paid or accrued by a corporation created or organized in a possession (possessions corporation) shall be treated as income from sources within such possession. For purposes of this paragraph (g)—

(A) The possessions source ratio shall be a fraction, the numerator of which equals the gross income of the possessions corporation from sources within the possession in which it is created or organized (applying the rules of this section) for the testing period, and the denominator of which equals the total gross income of the corporation for the testing period; and

(B) The term possessions shareholder means any individual who is a bona fide resident of the possession in which the corporation is created or organized and who owns, directly or indirectly, at least 10 percent of the total voting stock of the corporation.

(ii) *Dividends from corporations engaged in the active conduct of a trade or business in the relevant possession*. The entire amount of any dividend paid or

accrued by a possessions corporation shall be treated as income from sources within the possession in which it is created or organized when the following conditions are met—

(A) 80 percent or more of the gross income of the corporation for the testing period was derived from sources within such possession (applying the rules of this section) or was effectively connected with the conduct of a trade or business in such possession (applying the rules of § 1.937-3T); and

(B) 50 percent or more of the gross income of the corporation for the testing period was derived from the active conduct of a trade or business within such possession.

(iii) *Testing period*. For purposes of this paragraph (g)(1), the term *testing period* means the 3-year period ending with the close of the taxable year of the payment of the dividend (or for such part of such period as the corporation has been in existence).

(iv) *Subsidiary look-through rule*. For purposes of this paragraph (g)(1), if a possessions corporation owns (directly or indirectly) at least 25 percent (by value) of the stock of another corporation, such possessions corporation shall be treated as if it—

(A) Directly received its proportionate share of the income of such other corporation; and

(B) Actively conducted any trade or business actively conducted by such other corporation.

(2) *Dividends from other corporations*. In applying the principles of section 861 and the regulations thereunder pursuant to paragraph (b) of this section, the special rules relating to dividends for which deductions are allowable under section 243 or 245 shall not apply.

(h) *Income inclusions*. For purposes of determining whether an amount described in section 904(h)(1)(A) constitutes income from sources within the relevant possession—

(1) If the individual owns (directly or indirectly) at least 10 percent of the total voting stock of the corporation from which such amount is derived, the principles of section 904(h)(2) shall apply. In the case of an individual who is not a possessions shareholder (as defined in paragraph (g)(1)(i)(B) of this section), the preceding sentence shall

apply only if the corporation qualifies as a *United States-owned foreign corporation* for purposes of section 904(h); and

(2) In all other cases, the amount shall be considered income from sources in the jurisdiction in which the corporation is created or organized.

(i) *Interest*—(1) *Interest from certain possessions corporations*—(i) *In general.* Except as provided in paragraph (i)(1)(ii) of this section, with respect to any possessions shareholder (as defined in paragraph (g)(1)(i)(B) of this section), interest paid or accrued by a possessions corporation shall be treated as income from sources within the possession in which it is created or organized to the extent that such interest is allocable to assets that generate, have generated, or could reasonably have been expected to generate income from sources within such possession (under the rules of this section) or income effectively connected with the conduct of a trade or business within such possession (under the rules of § 1.937-3T). For purposes of the preceding sentence, the principles of §§ 1.861-9 through 1.861-12 shall apply.

(ii) *Interest from corporations engaged in the active conduct of a trade or business in the relevant possession.* The entire amount of any interest paid or accrued by a possessions corporation shall be treated as income from sources within the possession in which it is created or organized when the conditions of paragraphs (g)(1)(ii) (A) and (B) of this section are met (applying the rules of paragraphs (g)(1) (iii) and (iv) of this section).

(2) *Interest from partnerships.* Interest paid or accrued by a partnership shall be treated as income from sources within a possession only to the extent that such interest is allocable to income effectively connected with the conduct of a trade or business in such possession. For purposes of the preceding sentence, the principles of § 1.882-5 shall apply (as if the partnership were a foreign corporation and as if the trade or business in the possession were a trade or business in the United States).

(j) *Indirect ownership.* For purposes of this section, the rules of section 318(a)(2) shall apply except that the language “5 percent” shall be used in-

stead of “50 percent” in section 318(a)(2)(C).

(k) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. X, a U.S. citizen, resides in State N and acquires the stock of Corporation C, a domestic corporation, in 2000. X moves to the Northern Mariana Islands (NMI) in 2003. In 2004, while a bona fide resident of the NMI, X recognizes gain on the sale of the Corporation C stock. Pursuant to section 1277(e) of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085) (October 22, 1986), this gain is treated as income from sources within the United States for all purposes of the Internal Revenue Code (including section 7654, as in effect with respect to the NMI), and not as income from sources in the NMI.

Example 2. X, a U.S. citizen, resides in State F and acquires a 5 percent interest in Partnership P in 2003. X moves to the U.S. Virgin Islands (USVI) in 2004. In 2006, while a bona fide resident of the USVI, X recognizes gain on the sale of the interest in Partnership P. Pursuant to paragraph (f)(1) of this section, the gain shall not be treated as income from sources within the USVI for purposes of the Internal Revenue Code (for example, for purposes of section 934(b)).

Example 3. X, a bona fide resident of Possession I, a section 931 possession (as defined in § 1.931-1T(c)(1)), is engaged in a trade or business in the United States through an office in State H. In 2005, this office materially participates in the sale of inventory property in Possession I, such that the income from these inventory sales is considered effectively connected to this trade or business in the United States under section 864(c)(4)(B)(iii). This income shall not be treated as income from sources within Possession I for purposes of section 931(a)(1) pursuant to paragraph (c)(1)(ii) of this section, but nonetheless shall continue to be treated as income from sources without the United States under section 862 (for example, for purposes of section 904).

Example 4. (i) X, a bona fide resident of Possession I, owns 25 percent of the outstanding shares of A Corp, a corporation organized under the laws of Possession I. In 2006, X receives a dividend of \$70x from A Corp. During 2004 through 2006, A Corp has gross income from the following sources:

Year	Possession I sources	Sources outside possession I
2004	\$10x	\$20x
2005	20x	10x
2006	25x	15x

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(ii) A Corp owns 50 percent of the outstanding shares of B Corp, a corporation organized under the laws of Country FC. During 2004 through 2006, B Corp has gross income from the following sources:

Year	Possession I sources	Sources outside possession I
2004	\$10x	\$6x
2005	14x	8x
2006	10x	4x

(iii) A Corp is treated as having received 50 percent of the gross income of B Corp. Therefore, for 2004 through 2006, the gross income of A Corp is from the following sources:

Year	Possession I sources	Sources outside possession I
2004	\$15x	\$23x
2005	27x	14x
2006	30x	17x
Totals	72x	54x

(iv) Pursuant to paragraph (g) of this section, the portion of the dividend of \$70x that X receives from Corp A in 2006 that is treated as income from sources within Possession I is 72/126 of \$70x, or \$40x.

Example 5. X is a U.S. citizen and a bona fide resident of the Northern Mariana Islands (NMI). In 2005, X receives compensation for services performed as a member of the crew of a fishing boat. Ten percent of the services for which X receives compensation are performed in the NMI, and 90 percent of X's services are performed in international waters. X is a "United States person" as defined in section 7701(a)(30)(A). Accordingly, pursuant to section 863(d)(1)(A), the compensation that X receives for services performed in international waters is treated as income from sources within the United States for purposes of the Internal Revenue Code (including section 7654, as in effect with respect to the NMI). Under the principles of section 861(a)(3) as applied pursuant to paragraph (b) of this section, the compensation that X receives for services performed in the NMI is treated as income from sources within the NMI.

(1) *Effective date.* Except as otherwise provided in this paragraph (1), this section applies to income earned in tax years ending after October 22, 2004. Paragraph (c)(1) of this section applies to income earned after December 31, 2004. Paragraph (f) of this section applies to dispositions after April 11, 2005. Paragraphs (c)(2), (g)(1), (h), and (i) of

this section apply to amounts paid or accrued after April 11, 2005.

[T.D. 9194, 70 FR 18942, Apr. 11, 2005]

§ 1.937-3T Income effectively connected with the conduct of a trade or business in a possession (temporary).

(a) *Scope.* Section 937(b) and this section set forth the rules for determining whether income is effectively connected with the conduct of a trade or business within a particular possession (the relevant possession) for purposes of the Internal Revenue Code, including sections 881(b) and 957(c) and Subpart D, Part III, Subchapter N, Chapter 1 of the Internal Revenue Code. Paragraph (c) of this section does not apply, however, for purposes of section 881(b). In the case of a possession or territory that administers income tax laws that are identical (except for the substitution of the name of the possession or territory for the term *United States* where appropriate) to those in force in the United States, these rules do not apply for purposes of the application of such laws.

(b) *In general.* Except as provided in paragraphs (c) and (d) of this section, the principles of section 864(c) and the regulations thereunder (relating to the determination of income, gain or loss which is effectively connected with the conduct of a trade or business within the United States) shall generally be applied in determining whether income is effectively connected with the conduct of a trade or business within the relevant possession (except for the substitution of the name of the relevant possession for the term *United States* where appropriate), without regard to whether the taxpayer qualifies as a nonresident alien individual or a foreign corporation with respect to such possession. For purposes of the preceding sentence, all income other than income from sources within the relevant possession (as determined under the rules of § 1.937-2T) shall be considered income from sources without the relevant possession, and subject to the rules of this section, the principles of section 864(c)(4) shall apply for purposes of determining whether such income constitutes income effectively